No. 15174

In the United States Court of Appeals for the Ninth Circuit

AMERICAN PIPE & STEEL CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 49-79) are reported at 25 T. C. 351.

JURISDICTION

This petition for review (R. 647-651) involves federal income and excess profits taxes for the taxable years 1944, 1945, and 1946. On March 31, 1950, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiency in the total amount of $213,776.38. (R. 28-29.) Within ninety days thereafter and on May 29, 1950, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272(a) of the Internal Revenue Code

of 1939. (R. 3, 7-27.) The decision of the Tax Court was entered February 28, 1956. (R. 80.) The case is brought to this Court by a petition for review filed May 22, 1956. (R. 647-651.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

The sole question is stated in the stipulation of facts to be whether American Pipe & Steel Corporation is entitled to the tax benefits which it claimed in the consolidated returns for 1944, 1945, and 1946, by reason of its acquisition of the entire stock of Palos Verdes Estates, Inc.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations involved are set forth in the Appendix, *infra*.

STATEMENT

The facts of this case, some of which were stipulated or otherwise undisputed, are as follows:

The taxpayer is the American Pipe & Steel Corporation (hereinafter referred to as American Pipe), organized under the laws of the State of Nevada on May 27, 1929. It maintains its principal place of business in Alhambra, California. During the tax years, and to the date of this proceeding, it kept its books and filed its income tax returns on a calendar year basis. (R. 51.)

Palos Verdes Estates, Inc. (hereinafter called Palos Verdes), was organized under the laws of California on March 11, 1935. During the tax years it had its principal office in Alhambra, California. Prior to the acquisition of its capital stock by American Pipe, Palos Verdes used the fiscal accounting year ending on February 28. Effective from December 2, 1943, this fiscal

year was changed with permission of the Commissioner of Internal Revenue to the calendar year. (R. 51-52.)

American Pipe filed consolidated income tax returns for each of the years 1943, 1944, 1945, and 1946, in which returns were included the operations of Palos Verdes, as a wholly-owned subsidiary, beginning with the period December 3, 1943, to December 31, 1943. Such returns showed consolidated normal tax net income or losses, which were the result of consolidating the net income of American Pipe with the net losses of Palos Verdes, as follows (R. 52):

Taxable Year	American Pipe Net Income or (Loss)	Palos Verdes Net Income or (Loss)	Consolidated Net Income or (Loss)
1943	$ 16,880.52	($245,800.74)	($228,920.22)
1944	96,515.44	($419,329.90)	($322,814.46)
1945	144,909.04	($272,164.94)	($127,255.90)
1946	316,644.17	($148,632.80)	$168,011.37

The amounts stated in the Palos Verdes column and in the Consolidated column for the taxable year 1944, reflect a carry-over of claimed net operating loss of Palos Verdes for the period December 3, 1943, to December 31, 1943, deducted on the consolidated return filed for the year 1944 in the amount of $215,639.88. The amounts stated in the Palos Verdes column and in the Consolidated column for 1945 and 1946 reflect carry-overs of claimed net operating losses for the first and second preceding years of Palos Verdes deducted on the consolidated returns filed for 1945 and 1946, in the amounts of $322,814.46 and $107,174.58, respectively. (R. 52-53.)

At the time of filing the consolidated return for the year 1943, a separate return was also filed by Palos Verdes for the period begun March 1, 1943, and ended December 2, 1943. The books of Palos Verdes were closed for this purpose on December 2, 1943. (R. 53.)

The Commissioner, by letter dated March 3, 1950, notified American Pipe of his determination that the losses incurred by Palos Verdes in 1943 and 1944 could not be offset against the income of American Pipe during the tax years 1944, 1945 and 1946, and that the two corporations could not file consolidated tax returns for those years. (R. 28-31.) The resulting deficiencies proposed against American Pipe were as follows (R. 50):

Year	Tax	Deficiency
1944	Income	$23,504.02
	Excess Profits	34,955.02
1945	Income	17,753.50
	Excess Profits	84,299.14
1946	Income	53,264.70

As of December 2, 1943, the principal assets of Palos Verdes consisted of approximately 695 lots in the vicinity of Palos Verdes, California. These lots had been sold and transferred by tax deeds to the State of California on or about July 1, 1938, for nonpayment of taxes for the year 1931-1932 totaling $97,406.39. Palos Verdes had been in poor financial condition since 1936. (R. 53.) Its predecessors, seeking to promote the same project, also had experienced financial disaster since at least 1921. (R. 559-561, 586.) The period between 1938 and 1943 was the worst in its financial history. The lots owned by Palos Verdes were in a restricted residential area with a specified minimum cost for houses built therein. These restrictions were supervised by lot owners who composed The Palos Verdes Home Association and a committee known as the "Art Jury". Originally in 1920, the lots held by Palos Verdes embraced a larger tract. As early as 1937, Palos Verdes had unsuccessfully tried to interest buyers and contractors in combining with it in the erection of houses as an attraction for the sale of its remaining lots.

Much of the property was wholly or partly without improvements as to roads and utilities. It had, in 1942, three employees, two of whom were on a part-time basis. (R. 53-54.)

The stock control of American Pipe, during 1942 and all subsequent taxable years in issue in this proceeding, rested in Jack Lane and W. G. Krieger, who were partners or associates in the purchase of approximately 96 per cent of the outstanding shares thereof. Their interests in the shares were equal. At all times pertinent to the issues in these proceedings, Lane was the president of American Pipe and Krieger was secretary or secretary and treasurer. (R. 54.)

Aside from a brief period, Lane had been associated with American Pipe since about 1928. He was vice-president thereof from the time he acquired his 48 per cent stock interest until in or about 1942 when he became president. He had previously been credit manager for about 10 years. Although largely self-educated, he had experience in various departments of an oil company, including the production and auditing departments. Lane had an extensive background in many phases of the local real estate business, including the development of tracts, management and selling of properties through his own concern. He had long been familiar with real estate in the Palos Verdes area, having acquired a real estate broker's license in 1937, at which time he opened a real estate office four miles north of Palos Verdes. (R. 54-55.)

American Pipe was principally engaged in the steel fabricating business, its main products being pipe and different types of tanks, fabricated products of steel, aluminum and other alloys. Some of the larger items

were field fabricated. More than 500 different products were manufactured. (R. 55, 353-355; Ex. 35.)

In May of 1942, American Pipe began negotiations with the War Production Board in San Francisco concerning the building of 25,000 forge welded containers or tanks for lethal gas. Prior to these negotiations American Pipe had been engaged on its own, and through subcontractors, in other war contracts, manufacturing various types of material for the war effort. (R. 55, 356.)

The specifications for the lethal gas containers called for a particular process of manufacture unfamiliar to American Pipe. After several trips east to inspect the plants of other firms making similar containers, Lane and American Pipe's engineer arrived at an estimate which Lane submitted as a preliminary bid for the contract on June 26, 1942. (R. 55, 360-362.) The War Production Board turned the matter over to the Chemical Warfare Service in San Francisco for further negotiations. In July of 1942, Lane felt that the contract would be awarded to American Pipe. (R. 55, 359.) On September 3, 1942, American Pipe received a written contract from the Chemical Warfare Service to produce 25,000 containers for $3,500,000. (R. 55-56, 365.) A new plant had to be constructed and it was March or April, 1943, before production of containers was commenced. (R. 364.)

Robert P. Archer had known Jack Lane since 1932. (R. 136.) Over the years Archer had been engaged in several facets of the real estate business (R. 119-126), and was a licensed real estate broker in the Los Angeles area for much of the period from 1926 through 1942 (R. 126-127). He met Ben Haggott, president of Palos

Verdes, in 1926 or 1927 and assisted him (Haggott was considerably younger than Archer) in learning real estate appraisal. They became good friends. (R. 127-129.) Haggott became president of Palos Verdes on February 2, 1938. (R. 129.) Archer was well aware of the distressed financial position of Palos Verdes. (R. 130.)

Lane and Archer first discussed Palos Verdes at their meeting on May 29, 1942, during the course of their discussion about Lane's efforts to obtain the chemical warfare contract. (R. 136-137, 343-344.) Archer testified that he had no assets, but had become interested in acquiring the stock of Palos Verdes. (R. 131.) He was of the opinion that the tax sale could be set aside. (R. 131-132.) Lane was aware of the fact that substantial tax liens would have to be paid to clear title on the lots. (R. 490.)

Lane was interested in Archer's acquaintance with Major English who was in charge of the Los Angeles branch office of the Chemical Warfare Service. (R. 137, 344.) Within a day or two Archer arranged a meeting of Lane and Major English to discuss American Pipe's chances of obtaining the chemical warfare contract. Major English told Lane that the contract was outside his jurisdiction. (R. 344-345.) No further contact was had with Major English about this contract. Archer knew no one else at the Chemical Warfare Service. (R. 173-174.)

The testimony is that Lane thereafter suggested that Archer work for American Pipe as an expediter in connection with the chemical warfare contract (R. 345), and Archer agreed to take the job at $100 a week provided that American Pipe would loan him $2,500

to help him finance the purchase of the stock of Palos Verdes. Archer was to have the necessary free time that he would need to acquire the stock of Palos Verdes. (R. 136-139, 345-346.) Archer was employed by American Pipe on August 12, 1942, on which date he was placed on the payroll as an accountant. He had never engaged in accounting work. (R. 56-57.)

On August 18, 1942, an escrow account was opened with the Bank of America in the name of "R. P. Archer" with $1,000 advanced by American Pipe. Archer knew that the going market price for shares of Palos Verdes stock was 25 to 50 cents a share. Nevertheless, he determined to offer the stockholders $2 a share. (R. 57, 145-146.) An offer was drawn on August 18, 1942, and sent to the stockholders with a letter from Haggott explaining the extremely poor present and prospective position of Palos Verdes and suggesting that Archer's offer presented a means of their salvaging something. (R. 150-154.) The offer of $2 a share was binding only if Archer could purchase 70 per cent of the stock. (R. 154-155.) His stated purpose in wanting 70 per cent of the stock was to be able to pass a resolution imposing an assessment of about $40 a share on those stockholders who would not sell, and thereby freeze them out. In this manner 100 per cent of the stock would be acquired. (R. 58, 229-230, 236-237.) Archer knew that 51 per cent of the stock was a controlling interest, and had no explanation of why he insisted on 100 per cent. (R. 237-238.)

The offer of $2 a share which was circulated among the stockholders of Palos Verdes was signed "R. P. Archer, Nominee". (Ex. 4.) Archer knew that the word nominee appeared on the offer, and he knew that a person cannot be his own nominee. He could not ex-

plain how the expression happened to be used on the offer and insisted that he was no one's nominee, but purchased the stock for himself. (R. 214-215.) He admitted that at the time he offered to buy the stock he knew that back taxes amounted to between $80,000 and $100,000, and that he did not have the financial ability to pay them off. (R. 217-218.) He was personally without funds, had alimony commitments, and was virtually "broke". (R. 57.)

Archer stated that the $2 figure was offered instead of the market price of 50 cents because a round figure like $2 is more attractive than a figure representing a fraction of a dollar, and because it was higher than the market price (400 per cent higher) and "one that I could afford to pay". (R. 145-146.) Lane knew that Archer was paying $2 a share. (R. 487.) American Pipe advanced the funds. (R. 487-488.)

As a result of the offer and the accompanying letter of Mr. Haggott (Ex. 3, R. 150-154), slightly more than 2,500 shares of Palos Verdes stock came into the escrow account over a six- to ten-month period. (R. 156.) The acquisition of the 2,500 shares was financed entirely by American Pipe, which advanced between $6,000 and $7,000. (R. 57, 157.)

Having lost title to all its remaining real estate assets by reason of nonpayment of Los Angeles county taxes for the year 1931-1932, and tax deeds therefor having been given by the tax collector to the State of California on July 1, 1938, Palos Verdes, on July 27, 1943, instituted an action in the Superior Court of the State of California against the State of California and other taxing authorities to set aside the tax sales and tax deeds with respect to 695 lots. On August 2, 1943, the Court entered an interlocutory decree based

upon a stipulation of the parties concerned, and set aside the tax sales and tax deeds to the lots involved in such action. The decree restored the rights of redemption free of interest, penalties and costs, but limited the extension of time so to redeem by requiring payment of all such delinquent taxes, as corrected, to be made within six months after the decree became final. (R. 58-59.) Mr. Roy Dolly, the lawyer for American Pipe, prepared the stipulated interlocutory decree for Palos Verdes. (R. 61, 492.)

More than a month before the commencement of the tax title redemption action, a sufficient percentage of shares had been acquired to enable the amendment of the Articles of Incorporation of Palos Verdes so as to permit the levying of assessments upon the stock of Palos Verdes; and, at a special meeting on June 23, 1943, the board of directors of Palos Verdes adopted a resolution to this end. On August 26, 1943, an assessment of $40 a share was levied and the resolution, which so levied the assessment, provided for a certain day, September 27, 1943, for payment of such assessment, and further provided and fixed the time at which delinquent stock would be placed on sale or forfeited if unsold. The date originally selected for sale or forfeiture of Palos Verdes stock, October 15, 1943, was postponed until December 2, 1943. (R. 59.)

None of the holders of record of Palos Verdes offered to pay the assessment of $40 plus five per cent delinquency penalty on each share of stock held by them. The only person to appear and bid upon any portion of stock offered at the assessment sale was Archer who bid upon and purchased 96 shares of stock, held by seven individuals, for a total of $4,032. In bidding upon the 96 shares, Archer was acting for Ameri-

can Pipe and the funds used by Archer to purchase such shares were furnished to him for that purpose by American Pipe. Title to the 96 shares bid in by Archer was taken by Archer in his own name. The shares purchased through escrow and at the assessment sale constituted all of the outstanding stock of Palos Verdes. In confirming Archer's purchase of the 96 shares of stock, the directors, on December 2, 1943, the same day as the sale, declared all other shares forfeited for failure of any person to pay the assessment plus penalty thereon. (R. 59-60.)

Archer relinquished his control over the 2,500 shares to American Pipe late in 1943, in return for cancellation of his indebtedness. (R. 162-163.) As a result of the purchase of 96 shares by Archer in behalf of American Pipe, on December 2, 1943, American Pipe became the owner of all the outstanding shares of stock of Palos Verdes. Such stock was obtained by American Pipe at a total cost of $11,248.96, which figure includes the $4,032 paid for the 96 shares purchased by Archer at the assessment sale, as well as the funds furnished to Archer for the purchase of approximately 2,600 shares through the escrow procedure. (R. 60.)

Beginning with December 3, 1943, and continuing through the periods involved in these proceedings, Palos Verdes was a wholly-owned subsidiary of American Pipe. Prior to its acquisition by American Pipe, the fiscal year of Palos Verdes ended on the 28th day of February, whereas American Pipe filed its returns on the calendar year basis. Both taxpayers used the accrual basis of accounting. American Pipe caused Palos Verdes' fiscal year to be changed to the calendar year effective from December 2, 1943, and American Pipe further caused consolidated returns to be filed

for the short 1943 period, as well as for the subsequent years here involved. (R. 60-61.)

When Archer went on American Pipe's payroll he owned his own firm, Archer Machine Products, which was just starting operations. (R. 139-140.) During part of the time that he was employed by American Pipe he worked for Midland Ordnance, a firm in Illinois. (R. 139.) His time was broken up, he testified, among his various interests of acquiring Palos Verdes stock, taking care of his own Archer Machine Products, working for Midland Ordnance, and doing "a little expediting for American Pipe and Steel Company". (R. 146.) It is not clear for just how long after December 2, 1943, Archer continued on the American Pipe payroll. At the very longest it was a period of but several months. (R. 139.) During the tax years involved and to the date of this proceeding Archer owned an interest in a project in Glendale. The other owners are Jack Lane, Carl Dahlberg, and Roy Dolley. (R. 61, 298.)

Jack Lane testified that he became interested personally in Palos Verdes, but could not raise the funds to liquidate the tax liens; that he later developed a plan whereby Palos Verdes could be used by American Pipe; that in pursuance of this plan he suggested in a letter to the board of directors dated November 25, 1943, the uses to which it could be put. (R. 376-381.) The letter is set out verbatim in the Tax Court's findings (R. 67-72) and states that certain advantages would accrue to American Pipe by acquiring Palos Verdes. Lane admitted on cross-examination that the stated advantages would largely have been available to American Pipe by forming a new corporation. (R.

501-503.) On the same date, November 25, the board of directors of American Pipe adopted a resolution authorizing Lane to purchase the stock of Palos Verdes. (R. 73.)

Almost immediately after December 2, 1943, and beginning on December 23, 1943, Lane caused several advertisements to be run in the Los Angeles newspapers announcing the "liquidation sale" of Palos Verdes Estates. (Exs. 9 and 10; R. 61, 285-286.) Mr. Carl B. Dahlberg, who had known Lane for more than ten years, and who is now vice-president of American Pipe, was the only interested purchaser. (R. 61, 275-276.) He was permitted to purchase 451 lots for $16,000, at $40 per lot, plus assumption of the taxes of $10,000. He paid no cash, giving instead his personal four-year five percent note dated December 28, 1943, in the amount of $18,000. When the taxes became due in a few months, Palos Verdes advanced the funds taking in exchange Dahlberg's four-year five per cent note for $9,884.83. A deed was given him December 30, 1943. His wife executed in his favor a quit claim deed. (R. 62-63, 289-291.) At no time did Dahlberg make any cash payments on the principal of the notes or the interest. (R. 63, 302.) He knew at the time he supposedly purchased the lots that war-time restrictions prohibited any possible building. (R. 302-303.) Roy Dolley, American Pipe's attorney, was Dahlberg's attorney in the matter of his purchase of Palos Verdes lots. (R. 300.)

Some four years later, on January 28, 1948, Dahlberg reconveyed by grant deed to Lane personally the lots he held which had not been lost for taxes. The terms of the reconveyance were that if and when Lane sold

the lots, the first $37,000 was to be used to extinguish Dahlberg's liability for the principal and interest on the two notes he issued. Any amount realized over $37,000 was to belong to Lane. Dahlberg retained no interest in the property. (R. 63; Ex. 16, R. 316-318.)

The basis to Palos Verdes of the lots purportedly sold to Dahlberg in 1943 was $250,781, and the resulting paper loss on the books of Palos Verdes was $232,781. This loss was reflected on the consolidated returns filed for the period from December 3, 1943, to December 31, 1943, by American Pipe and Palos Verdes as an operating loss of Palos Verdes. (R. 64.)

On January 15 and 16, 1944, American Pipe caused the balance of the lots remaining after the Dahlberg sale to be put up for public auction. The public auction was under the direction of Dean S. Bedilion, a well-known local real estate auctioneer. The advertisements for this auction which appeared in local newspapers stressed the fact that the lots to be sold represented "The Last of the Better Residential Districts in Southern California". The lots which were sold at auction netted $16,185 after costs of sale. The basis to Palos Verdes of the lots sold was $183,797.91. The resulting loss of $167,612.91 was reflected on the consolidated returns filed for 1944. Some additional lots were sold at private sales, after the date of the auction, some of them for around $500 each. The remainder of the lots not redeemed or sold by Palos Verdes was lost under the terms of the Final Decree of the Superior Court entering judgment to quiet title in the State of California. This Decree was entered on May 15, 1944. Final judgment in favor of Palos Verdes on all lots redeemed by payment of delinquent taxes was entered

on March 16, 1945. This judgment in favor of Palos Verdes, on all lots redeemed, operated for the benefit of its grantees, inasmuch as it no longer owned any lots in Palos Verdes tracts. (R. 64-65.)

Subsequently, in 1947, the State of California put up for sale some of the lots unredeemed and lost by Palos Verdes. At this sale, Lane personally bought for his own account as many lots as he could afford to purchase at that time and now owns altogether approximately 300 lots. (R. 65.) When asked why American Pipe did not reacquire these lots, rather than himself personally, Lane answered that his associates felt that "the real estate business was not germane to the steel business and they had no business having a subsidiary in the real estate business". (R. 457.)

When asked, in view of American Pipe's stated purpose to utilize the lots, why it immediately sold at sacrifice prices or otherwise lost all of the lots, Lane suggested two answers. First, the sale to Dahlberg was in the expectation that he would immediately start building houses, thereby appreciating the value of the lots retained by Palos Verdes. (R. 503-504.) It was common knowledge, however, that war-time housing restrictions barred any such plan, and Lane knew this. (R. 496-498.) The housing restrictions were never lifted; they expired sometime after the war. (R. 513.) Lane's main explanation was that as of December 2, 1943, the date he claims that American Pipe acquired ownership of Palos Verdes, he did not know that under the terms of the interlocutory decree the taxes had to be paid within six months. (R. 405-406.) He stated that Mr. Dolley, who prepared the stipulated interlocutory decree, and who was also American Pipe's lawyer,

did not advise him of the terms of the decree. (R. 492.) He admitted that he was familiar with Exhibit 24 which showed the total taxes due and which referred to the interlocutory decree. (R. 493.)

Lane denied that American Pipe's accountants secured working papers of Palos Verdes in August of 1942 to examine its financial position. (R. 485-486.) Mr. Wilford G. Edling, a certified public accountant and auditor for American Pipe during 1942, identified Exhibit T as a receipt signed by himself on August 15, 1942, witnessing that he took from Roy W. Burton a folder file of Palos Verdes of February 28, 1942, and Union Bank Trustee return of foreclosure sale. Edling stated that the only person who might have directed him to obtain these items would have been Mr. Lane of American Pipe. (R. 572-573.)

American Pipe experienced serious trouble in its attempted performance of the chemical warfare contract, especially concerning interpretation of the specifications. (R. 364, 366-368.) American Pipe had not maintained the schedule called for under the contract, partly through its own fault and partly through conditions over which it had no control. (R. 372.) Lane was notified that a more lethal gas had been discovered which could not be packaged in the containers being manufactured by American Pipe, and that the contract was, therefore, to be terminated. (R. 369.) He was informed by the San Francisco office that there was no chance it would be cancelled for cause; it was to be cancelled for the convenience of the Government. (R. 373.) The contract was terminated by written notice dated September 29, 1943. It stated that the cancellation was

for the necessity and convenience of the Government, and American Pipe would be compensated for the uncompleted portion of the contract. (Ex. 27; R. 420-422.) In October, 1943, American Pipe filed a claim in the amount of $1,252,000, which included the amount for the erection of its new plant at Alhambra to manufacture the containers. (R. 67.) A final settlement allowing American Pipe $1,050,000 was reached in the last few days of December, 1943, or early in January, 1944. (R. 67, 374-375.) American Pipe reported an operating loss on the contract of $116,240.30, reducing its separate net profit in 1943 to $16,880.52. (R. 67.)

American Pipe produced Exhibit 31, which was a schedule of contracts awarded in 1943, and which indicated a backlog as of December 31, 1943, of prime Federal Government contracts amounting to $850. This purportedly represented the backlog on such contracts awarded in 1943 in the amount of $224,648. It did not include the chemical warfare contract which had been terminated in September, 1943. The total did not include the backlog of subcontracts for war materials not completed as of December 31, 1943, amounting to $123,753. (Ex. 31; R. 74-75, 429-431.) Lane had stated in the Cancellation Claim submitted to the Government on October 14, 1943, that immediate reimbursement on the cancelled contract was necessary because American Pipe was left without operating funds, and "We have a substantial backlog of war work". (Ex. 28; R. 67.)

As of December 31, 1944, American Pipe had a backlog of prime Federal Government contracts amounting to $1,006,275, on total contracts awarded during the year of $1,892,144. (Ex. 44; R. 75.) This total did not include subcontracts for war materials, of which the

amount not completed as of December 31, 1944, was $14,213. (R. 75.)

American Pipe had allocated all its labor plus any other it could obtain to its production under the chemical warfare contract. More war work could have been performed except for the labor shortage. (R. 527-528.)

The Tax Court affirmed the Commissioner's determination. (R. 79.)

SUMMARY OF ARGUMENT

A. The application of Section 129 serves to deny the taxpayer the right to offset Palos Verdes' losses against American Pipe's profits on consolidated tax returns. This section denies deduction, credit, or allowance where the taxpayer has acquired on or after October 8, 1940, at least 50 per cent control of a corporation, the "principal purpose" of which was tax avoidance by securing the deduction, credit, or allowance, which would not otherwise have been available. For Section 129 to be applicable the tax purpose need not constitute the sole purpose, nor must it exceed in importance the sum of all other purposes. It is sufficient if the tax avoidance purpose was more prominent than any other one purpose. The question of purpose, that is, the intent with which the acquisition was made is one of fact for the trial judge, the resolution of which will not be disturbed on apeal if supported by substantial evidence.

The sole dispute regarding the application of Section 129 in this case concerns whether the "principal purpose" of the acquisition was to avoid taxation. The evidence clearly *shows* that it was. The significant factors are as follows:

At the same time that the stock of Palos Verdes was acquired by American Pipe, the latter's prospective in-

come situation was very bright. It had large war contracts, and the prospects of obtaining further contracts were excellent, as is borne out by examining its earnings for 1944, 1945 and 1946. On the other hand Palos Verdes had consistently been a business failure, and its future prospects at the time it was acquired by American Pipe were bleak. The situation was tailor-made for the type of tax avoidance scheme at which Section 129 is aimed. The comparative earnings situation of the two corporations takes on added emphasis by the failure of the taxpayer to show any legitimate business purpose for the acquisition.

The figure of $2 which was paid by American Pipe for each share of stock was four times the normal market price. This premium undoubtedly represented the cost of the tax losses purchased.

The loss was realized immediately after the total acquisition of Palos Verdes' stock. This emphasizes the fact that American Pipe had no business purpose for the acquisition, but purchased the stock solely to get its hands on the losses.

The record shows not only that taxpayer's principal purpose was tax avoidance, but that it was its sole purpose.

The Tax Court's decision was based on an examination of the entire record. It did not base its decision on the presumption of correctness of the Commissioner's determination.

B. The taxpayer was not entitled to file consolidated returns regardless of the purpose behind its acquisition of the stock of Palos Verdes. Section 129, which requires for its applicability that the principal purpose

of acquisition be tax avoidance, is not the exclusive section to which the Government may resort.

American Pipe acquired all the stock of Palos Verdes for $11,248. On the sale of the lots Palos Verdes suffered a book loss of $400,394. The real economic loss was suffered by the old stockholders of Palos Verdes, who sold out to American Pipe for a price far below the original invested capital contributions. **Section 141,** which allows the filing of consolidated returns, cannot be so taken advantage of as to permit American Pipe, regardless of its reasons, to blatantly purchase $400,394 worth of someone else's losses for a pittance, and offset such fabricated losses against its own income.

The privilege of filing a consolidated return, with accompanying advantage of inter-company offsets, is a departure from the underlying rule confining allowable losses to the taxpayer sustaining them. It reflects a recognition that where an affiliated group as a whole does not show a profit, it would be unfair, for example, to tax the profitable parent corporation without permitting the losses of the unprofitable subsidiary to be offset. But it is basic to this reasoning that where the losses of the subsidiary are in no way experienced in an economic sense by the parent, offset against the parent's profits should not be allowed. The congressional purpose was to limit the privilege of filing a consolidated return to the situation where not only did the subsidiary incur a tax loss, but the parent corporation sustained an economic loss as a result. Where, as in the instant case, neither the parent corporation nor its stockholders have suffered any economic loss from the operations of the subsidiary, all reason for allowing a consolidated return vanishes. To rule otherwise would be to stretch

the application of Section 141 to a situation outside the scope of the congressional purpose.

ARGUMENT

The Losses of Palos Verdes Cannot, by Means of Consolidated Tax Returns, Be Offset by American Pipe Against Its Gains

A. *American Pipe was not entitled to file consolidated tax returns because of Section 129*

1. *Section 129 in general*

This case involves an illustration of the constant search by taxpayers for loopholes in the tax statute. By 1940 various schemes designed to avoid taxation by intercorporate transactions were not uncommon. At first Treasury officials felt that the trend of court decisions (notably *Woolford Realty Co.* v. *Rose*, *supra*; *Gregory* v. *Helvering*, 293 U.S. 465; *Higgins* v. *Smith*, 308 U.S. 473) made it unnecessary to seek additional legislation. But by the middle of 1943 these schemes became quite numerous and widespread. The Treasury, to play safe, sought legislative help. Section 129 of the Internal Revenue Code of 1939 (Appendix, *infra*) was added to strengthen its position in knocking down acquisitions designed principally to achieve a tax benefit not otherwise available. See Rudick, Acquisitions to Avoid Tax, 58 Harv. L. Rev. 196, 199 (1944).

The pertinent language of Section 129 is as follows:

> If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, * * * and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other

> allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. * * * control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

Taxpayer concedes that it was not entitled to the consolidated tax returns if Section 129 is applicable. (Br. 31.) In return, the applicability of the section depends upon the satisfaction of three prerequisites: (1) The taxpayer must have acquired on or after October 8, 1940, at least 50 per cent control of a corporation; (2) the "principal purpose" behind the acquisition must have been tax evasion or avoidance; (3) by securing a deduction, credit, or allowance which would not otherwise have been available.

It is not disputed that American Pipe acquired control of Palos Verdes after October 8, 1940, and that the claimed deduction or allowance for Palos Verdes' losses was available solely as a result of this acquisition. The sole dispute regarding the application of Section 129 concerns whether the principal purpose of the acquisition was to evade or avoid Federal income or excess profits taxes.

The legislative purpose behind Section 129 is clear. As stated in 7A Mertens, Law of Federal Income Taxation, 1954 Cum. Pocket Suppl., Sec. 42.145(a), p. 299:

> Congress, in connection with the Revenue Act of 1943, recognized and sought to put a stop to the growing tax avoidance device of buying up corporations having losses, excess profits credits, or a large

> invested capital base, in order to improve the tax situation of the purchaser.

The legislative history of the bill is carefully traced in *Commodores Point Terminal Corp.* v. *Commissioner,* 11 T. C. 411. See also Rudick, Acquisitions to Avoid Tax, 58 Harv. L. Rev. 196, 200-206 (1944). Concerning the meaning of "principal purpose" the Senate Finance Committee Report states that "the section should be operative only if the evasion or avoidance purpose outranks or exceeds in importance, any other one purpose". S. Rep. No. 627, 78th Cong., 1st Sess., p. 59 (1944 Cum. Bull. 973, 1017). Likewise the Treasury Regulations (Regulations 111, Sec. 29.129-3) specify that—

> If the purpose to evade or avoid Federal income or excess profits tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of Section 129 which would not have been made if the evasion or avoidance purpose was not present.

It is thus clear that the tax purpose need not constitute the sole purpose, nor must it exceed in importance the sum of all other purposes. It is sufficient to invoke Section 129 that the tax avoidance purpose was more significant than any other one purpose.

The question of purpose, that is, the intent with which the acquisition was made, is one of fact for the trial judge (*Alcorn Wholesale Co.* v. *Commissioner,* 16 T. C. 75, 89), the resolution of which will not be disturbed on appeal if supported by substantial evidence, due regard being given to the opportunity of the trial court to judge of the credibility of the witnesses. See Federal Rules

of Civil Procedure, Rule 52; *United States* v. *Yellow Cab Co.,* 338 U. S. 338; *United States* v. *Real Estate Boards,* 339 U.S. 485; *Wisdom* v. *United States,* 205 F. 2d 30 (C.A. 9th).

The decisions under Section 129 are few. If any one conclusion can be drawn, it is that the issue being factual, the resolution of each case must turn on its peculiar facts. *Alcorn Wholesale Co.* v. *Commissioner,* 16 T. C. 75, involved the common situation of a corporation deciding to incorporate each of its branch operations. It was shown that by so doing the position of the business was strengthened by having increased borrowing power, more limited liability, the elimination of prejudice against absentee ownership, and greater facility in handling competitive lines. The split-up was initiated for these business reasons. Inasmuch as the split-up was not principally for tax purposes, Section 129 was not applicable, and each corporation was entitled to the specific excess profits tax exemption of $10,000 under Section 710 (b) of the Code. This split-up situation was also involved in *Berland's Inc. of South Bend* v. *Commissioner,* 16 T.C. 182, and *Chelsea Products, Inc.* v. *Commissioner,* 16 T.C. 840, affirmed, 197 F. 2d 620 (C.A. 3d). Each case was decided for the taxpayer on essentially the same showing of business purpose.

The tax advantage sought in *Commodores Point Terminal Corp.* v. *Commissioner,* 11 T.C. 411, was not dependent upon control of the acquired corporation. The dividends received credit (see Section 26(b) of the Code) would have been available even had the taxpayer acquired less than 50 per cent of the acquired corporation. Furthermore the taxpayer's primary purpose was to obtain working funds, a business reason. And it was

not a case of a corporation with large earnings acquiring a corporation with past, current, or prospective losses, or unused excess profits credits.

The principal purpose of the merger in *W A G E, Inc.* v. *Commissioner,* 19 T.C. 249, was to furnish working capital to the needs of the acquired corporation. This was held to be a business purpose.

Strictly speaking, Section 129 was not applicable in *Alprosa Watch Corp.* v. *Commissioner,* 11 T.C. 240, because the tax year was for a period before the effective date of its operation. In any event, the facts show that the Eisner Company had to acquire an existing corporation in order to market the watches. This was the principal reason for acquiring the Esspi Corporation, and it was held to be a business reason.

In *Alpha Tank & Sheet Metal Mfg. Co.* v. *United States,* 116 F. Supp. 721 (C. Cls), the taxpayer deeded its property to the Delmo Company, which was organized and owned by taxpayer's stockholders, and took a lease back. The court upheld the disallowance of the monthly rental under Sections 45 and 129 because there was no legitimate business purpose for Delmo's existence.

While none of the above cases involved the use of consolidated returns, the legislative history of Section 129 shows explicitly that one of its purposes was to protect the basic policies of the consolidated returns provisions. S. Rep. No. 627, 78th Cong., 1st Sess., p. 60 (1944 Cum. Bull. 973, 1017); H. Conference Rep. No. 1079, 78th Cong., 2d Sess., p. 55 (1944 Cum. Bull. 1059, 1070).

As we stated above, the only conclusion to be drawn from the decided case is that since the question of "principal purpose" is one of fact, each case must be decided on its own facts.

2. *American Pipe's principal purpose of acquiring control of Palos Verdes was to avoid federal income and excess profits taxes*

There are several factors in this case, all of which point rather emphatically to the conclusion that the principal purpose of acquisition was tax avoidance.

(a) American Pipe's earnings compared with Palos Verdes' losses

During the tax years involved American Pipe had substantial earnings from war contracts. (R. 52.) On the other hand Palos Verdes had huge losses due to the decline in value of its assets, awaiting only the tax event of a sale to be realized. If Palos Verdes could be acquired for a nominal amount and its huge paper losses offset against American Pipe's war profits, taxation might be avoided in large measure. The situation was tailor-made for the type of tax avoidance scheme, the consummation of which Section 129 is aimed at.

Early in 1942 American Pipe's prospective earnings picture was very encouraging. It was in the heavy metal fabricating industry, and was capable of producing over 500 different products. The country was at war. A mere glance at Exhibit 35 will convince the Court that American Pipe was able to produce a variety of items necessary to the war effort. This Court may take judicial notice that American Pipe was certain to obtain war contracts. As a matter of fact by July of 1942 Lane felt confident that the chemical warfare contract, amounting to $3,500,000, would be awarded it, and on September 3, 1942, it was awarded. (R. 55-56, 359, 365.) During the negotiations, American Pipe had

been engaged on its own, and through subcontractors, in other war contracts, manufacturing various types of material for the war effort. (R. 55, 356.) With the addition of the chemical warfare contract, it was producing at maximum capacity under the existing labor conditions. (R. 527-528.)

Taxpayer asserts, however, that it was not until December 2, 1943, some two months after the chemical warfare contract was cancelled, on September 29, 1943, that it acquired the stock of Palos Verdes, and that at such time its prospective profits were uncertain. We submit that the plans to acquire Palos Verdes for American Pipe were begun in May, 1942, just after the negotiations for the chemical warfare contract started, and that Archer was an agent for American Pipe so that all his activities were in reality attributable to American Pipe. The following facts substantiate our position.

Lane and Archer first discussed Palos Verdes at their meeting on May 29, 1942, during the course of their discussion about Lane's efforts to obtain the chemical warfare contract. (R. 136-137, 343-344.) By July of 1942, Lane was confident the contract would be awarded to American Pipe. (R. 55, 359.) Very soon thereafter, on August 12, 1942, Archer was taken on the payroll. (R. 56-57.) Ostensibly Archer was hired to expedite the contract, but the contract was already certain to be awarded. Archer knew Major English of the Los Angeles office of the Chemical Warfare Service, but Major English told Lane in June of 1942 that the contract was outside his jurisdiction. No further contact was had with Major English. Archer knew no one else at the Chemical Warfare Service. (R. 173-174.) Yet

Archer was supposedly hired as an expediter after his sole contact of influence was seen to be useless. The record does not abound with descriptions of Archer's work as an expediter. To the contrary, he indicated that he spent little time and effort for American Pipe, unless it be considered, as we submit, that his efforts in acquiring the stock of Palos Verdes were on behalf of American Pipe. During the time he was on American Pipe's payroll he devoted attention to his own firm, Archer Machine Products, he worked for an Illinois corporation, he was busy acquiring stock of Palos Verdes, and he did "a little expediting for American Pipe and Steel Company". (R. 146.) For his expediting work he was paid $100 a week plus American Pipe's commitment to loan him $2,500 to help finance the purchase of Palos Verdes stock. (R. 136-139, 345-346.) He was placed on the payroll as an accountant, but had never engaged in accounting work. (R. 56-57.) His label as an expediter was a sham. For what, then, was he paid $100 a week? The answer is to acquire for American Pipe the stock of Palos Verdes. Archer was a good friend of Ben Haggott, the president of Palos Verdes, had known him since 1926 (R. 127-129), and was also well aware of the distressed financial position of Palos Verdes. (R. 130.) Haggott was of great help in persuading the stockholders to sell. He personally wrote a letter, which was distributed to all stockholders, stating the very poor future prospects of Palos Verdes, and that Archer's offer provided an opportunity to salvage something. (Ex. 3, R. 150-154.) In hiring Archer to purchase the stock, American Pipe was getting the services of someone who not only knew the inside working of Palos Verdes, but who could rely

on Palos Verdes' president to bring the deal off successfully.

It is not unreasonable to conclude that Lane also knew Palos Verdes' financial condition, if as he claims, American Pipe was to back the purchase of the stock, taking the stock as security. (R. 57.) Furthermore, Mr. Edling, the accountant and auditor for American Pipe, testified to the effect that he had obtained on August 15, 1942, for Mr. Lane, papers of Palos Verdes as of the end of its fiscal year 1942, at Lane's direction. (R. 573.)

Archer knew that there were large tax liens against the lots. He knew that Palos Verdes had never been successful. (R. 53, 130, 559-561.) He was also aware of the wartime building restrictions, and the restrictions imposed by the Palos Verdes Homes Association, which combined were certain to keep the value of the lots depressed until after the war. Furthermore, he was personally without funds, had alimony commitments, and was virtually "broke". (R. 57.) The interlocutory tax redemption decree allowed only six months to pay off the tax liens. (R. 61, 492.) Under these circumstances Archer's story that he was buying the stock for himself as an investment is just not plausible.

The offer which was supposedly made by Archer to the stockholders of Palos Verdes was signed "R. P. Archer, Nominee". (Ex. 4.) He knew that he could not be his own nominee, but he had no explanation of why the term was used. (R. 214-215.) We submit that he made the offer as the agent of American Pipe, and most likely inserted the word nominee in order to limit his liability in the event of a default.

The money to purchase the 2,500 odd shares was advanced entirely by American Pipe, and amounted to between $6,000 and $7,000. (R. 157.) At the opportune moment, just before American Pipe decided to realize the loss on the December, 1943, sale, Archer turned over all the stock in exchange for being relieved of his indebtedness to American Pipe. It seems that Archer suddenly realized that he could not raise the money to pay the taxes. It is interesting to note also that American Pipe did not have the available funds to liquidate the tax liens. (R. 506, 509.)

The offer of $2 a share was binding only if Archer could purchase 70 per cent of the stock. (R. 154-155.) His stated purpose was to have enough stock to pass a resolution imposing a prohibitive assessment on those stockholders who would not sell, and thereby freeze them out. In this manner the purchaser would be assured of having 100 per cent control. (R. 58, 229-230, 236-237.) The question arises as to why it was so important for Archer to have all the stock, so necessary in fact that the offer was conditioned on his acquiring 70 per cent. If a good profit could be made, as Archer stated he thought it could, why would he not settle for whatever percentage over 50 he could acquire? The answer is that it was American Pipe that was making the offer, and the tax scheme of offsetting Palos Verdes' losses on a consolidated tax return could be accomplished under the statute only if 95 or more per cent of the stock could be acquired. See Section 141(d).

The stipulated interlocutory decree of August 2, 1943, under which Palos Verdes could redeem the lots, was prepared by Mr. Roy Dolley, the lawyer for American Pipe. (R. 61, 492.) It should be noted that a suffi-

cient percentage of shares to levy the assessment had been acquired before commencement of the tax title redemption action. American Pipe was careful not to finally commit itself until it was certain of acquiring the requisite 95 per cent of the stock necessary to file a consolidated return.

In partial explanation of Archer's story that he was dealing for himself, it should be observed that he was not a completely disinterested witness. Aside from his long-standing friendship with Lane, he owns an interest in a project in Glendale, along with Lane, Dolley, and Dahlberg. (R. 61, 298.)

The inescapable conclusion from the above facts is that, in the purchase of Palos Verdes, Archer represented American Pipe from the moment he went on the payroll.

Taxpayer argues that the chemical warfare contract was cancelled before December 2, 1943, the date of the forfeiture sale, that it suffered a large loss on the cancellation of the contract, and thus had no tax reason for wanting to acquire Palos Verdes. There are several answers to this contention.

The assessment was levied on August 26, 1943, and it was at that time that the date for the sale or forfeiture of the remaining stock was set. (R. 59.) This was a month before Lane knew that the contract would be cancelled. (R. 369, 373, 420-422.)

More important, as of December 2, 1943, when American Pipe bid in 96 shares and caused the remaining 800 to 900 shares to be forfeited, no loss on the chemical warfare contract could have been anticipated. The contract was cancelled, not for cause, but because a more lethal gas had been developed which could not be packaged in the containers being manufactured under

the contract. (R. 369.) Lane was notified that there was no chance that the contract would be cancelled for cause, that it was to be cancelled for the convenience of the Government. (R. 373.) The written notice of termination, dated September 29, 1943, stated that the cancellation was for the necessity and convenience of the Government, and that American Pipe would be compensated for the uncompleted portion of the contract. (Ex. 27; R. 420-422.) The final settlement, on which basis American Pipe claimed an operating loss of $116,240 on the 1943 tax return, was not reached until the last days of December, or early in January. As of December 2, 1943, there was no reason to anticipate a loss because, according to the cancellation notice, American Pipe was to be compensated for the uncompleted portion.

Furthermore, with the defense industry booming there was every reason to believe that other contracts would quickly fill the place of the chemical warfare contract. Judging from American Pipe's productive capabilities (Ex. 35), and from this country's desperate need for war materiel, the Tax Court could well infer that additional defense contracts would quickly fill the temporary gap, as indeed they did. It needs but a glance at American Pipe's earnings to bear this out. In 1944 American Pipe was awarded prime Federal Government contracts amounting to $1,892,144, which when added to its subcontracts for war materiel, gave it a net profit of $96,515. (R. 52, 75.) Its net profits for 1945 jumped to $144,909, from which figure it more than doubled in 1946, to $316,644. (R. 52.) In view of the known war-time conditions which were certain to provide American Pipe with the huge profits it

earned, it seems capricious, indeed, for taxpayer to argue that it did not anticipate its future income position.

Therefore, even though American Pipe did not come into full ownership of Palos Verdes until after the cancellation of the contract, as of December 2, 1943, when the last shares were acquired, American Pipe's financial outlook was bright. It is not difficult to perceive that taxes were a major concern. As an incidental matter, it would seem to make very little difference whether or not Archer acted for American Pipe in acquiring the first 2,500 shares. Its income prospects were not dimmed by the cancellation of the contract. Even if American Pipe did not decide until the fall of 1943 to acquire Palos Verdes, this is perfectly consistent with our position that the acquisition was actuated in the main, if not solely, by tax avoidance considerations and, indeed, was used to avoid taxes.

(b) *The offer of $2 a share was 400 per cent higher than the going market price*

Both Archer and Lane knew that the going market price for Palos Verdes stock was 25 to 50 cents a share. (R. 152, 487.) Nevertheless the stockholders were offered $2 a share. Archer's explanation for the high premium was that a round figure like $2 is more attractive than a fraction of a dollar, and was a price that "I could afford to pay". (R. 145-146.) This is no explanation at all.

A much more logical explanation is that the stockholders of Palos Verdes were aware of the fact that American Pipe would be willing to pay a premium for the tax losses it was purchasing.

It has been common practice in the purchase of loss corporations to pay a price substantially in excess of true value. See Rudick, Acquisitions to Avoid Tax, 58 Harv. L. Rev. 196, 197 (1944). We submit that is what happened here.

(c) *The loss was realized immediately after final acquisition*

A very significant fact is that American Pipe caused Palos Verdes to immediately realize the built-in loss. Within a few weeks after the final acquisition and the forfeiture of the remaining outstanding shares, more than half the lots were purportedly sold to Carl Dahlberg.[1] This caused Palos Verdes to incur a loss of $232,781 which was offset against and wiped out American Pipe's profit for the year. The excess was carried forward to offset and wipe out American Pipe's profit for 1944. (R. 52-53, 64.)

American Pipe then caused the remaining lots to be put up for public auction on January 15 and 16, 1944. On the lots sold at the auction Palos Verdes realized a loss, on the basis of the book value, of $167,612. This was reflected on the consolidated return filed for 1944, and the excess was carried forward to offset in whole or in part American Pipe's profits for 1945 and 1946. (R.

[1] We say purportedly because even this transaction seems to have been a sham. Dahlberg, who had known Lane for ten years and who is now vice-president of American Pipe (R. 61, 275-276), was permitted to purchase 451 lots, for which he gave his note for $18,000. Roy Dolley, American Pipe's attorney, acted as Dahlberg's attorney in this matter. Palos Verdes advanced him the money to pay the taxes, for which he again gave his note. A deed was given him on December 30, 1943. (R. 62-63, 289-291.) He never paid any part of the principal or interest on the notes, and later reconveyed to Lane in exchange for the extinction of his debt. (R. 63; Ex. 16, R. 316-318.)

52-53, 64-65.) The remainder of the lots not sold was lost under the terms of the Final Decree of the Superior Court entering judgment on May 15, 1944, to quiet title in the State of California. (R. 64-65.)

Taxpayer's contention, of course, is that it acquired Palos Verdes for business purposes. But it is difficult to reconcile their position with their actions. Within a very short time after total acquisition, the entire assets of Palos Verdes were lost, leaving the mere corporate shell. Under almost identical circumstances the Board in *J. D. & A. B. Spreckels Co.* v. *Commissioner,* 41 B.T.A. 370, in deciding not to allow the consolidated return, was greatly influenced by the fact that the subsidiary (Tire Company) sustained the loss immediately after its acquisition by the parent company. The court had this to say (p. 375):

> In our determination of this question, the close relationship between the time when petitioner acquired the stock of the Tire Co. for $1, and the time when the Tire Co. sustained the loss of $192,849.80 on the sale of its plant, seems very pertinent.

Lane's explanation for the sudden liquidation is not convincing. The purported sale to Dahlberg was supposedly in the expectation that he would immediately start building houses, thereby appreciating the value of the lots retained by Palos Verdes. (R. 503-504.) It was common knowledge, however, that war-time building restrictions barred any such plan, and Lane knew this. (R. 496-498.) The building restrictions were never lifted; they expired some years after the war. (R. 513.)

Lane would also have the Court believe that as of December 2, 1943, he did not know that under the terms

of the interlocutory decree the taxes had to be paid within six months (R. 405-406), and that, therefore, since American Pipe did not have the money to pay the taxes (R. 506, 509), the lots had to be sold. Lane knew of the existence of the interlocutory decree (R. 493), yet claimed ignorance of its most significant terms. His explanation seems all the more incredible in view of the fact that it was Mr. Dolley, American Pipe's lawyer, who had prepared the decree. (R. 61, 492.) The fact finder would be warranted in finding it unbelievable that the lawyer who handled these transactions for American Pipe did not advise Lane of the critical terms of the decree.

The Tax Court's conclusion that American Pipe's principal purpose of acquisition was tax avoidance is amply supported in the record.

3. *The letter of November 25, 1943*

On November 25, 1943, Lane wrote a letter to the board of directors of American Pipe in which he detailed several reasons for acquiring Palos Verdes. (R. 67-72.) It is urged that these were business reasons, some of which have been carried out. Reason number 3 was to tie the lots in with the construction of steel houses, and thus provide a controlled outlet for the sale of steel houses. (R. 70.) Number 4 was to use the lots for storage equipment which would then be loaned to consumers. (R. 70-71.) It was also suggested that some of the lots could be set aside for the distribution of liquified gas to enhance the volume of containers. (R. 71.) These three reasons required retention of at least a few of the lots. Yet Palos Verdes sold or lost all the lots. Only the corporate shell remained. Their actions drown out their words.

Reasons numbers 1 and 2 (R. 69-70) are immaterial. They in no way contemplate the use of Palos Verdes' property. To the contrary, they merely express the desire to have a corporate structure in which title to other property might occasionally be taken. There was no showing that it was necessary to own Palos Verdes to fulfill this desire. Any corporate structure would have sufficed. American Pipe could have organized a new corporation which would have served just as well, as Lane admitted. (R. 501-503.) Furthermore, the organization of a new corporation could have been accomplished for a very few dollars by way of comparison with the $11,248 expended to acquire Palos Verdes. A business purpose contemplates that either the property or corporate structure has some unique business value to the acquiring corporation. There was nothing of inherent value in the corporate structure of Palos Verdes.

In 1947 Lane reacquired personally some of the lots lost by Palos Verdes. It is interesting to note that when asked why American Pipe did not reacquire these lots for its stated business purposes, he answered that his associates felt that (R. 457) "the real estate business was not germane to the steel business and they had no business having a subsidiary in the real estate business".

There is nothing in the letter of November 25, 1943, or in American Pipe's subsequent action, that detracts from the conclusion that American Pipe's principal purpose for acquiring Palos Verdes was tax avoidance.

4. *The Tax Court's decision was based on an examination of the entire record*

The taxpayer has used a considerable portion of his brief in an attempt to convince the Court that the Tax

Court did not found its decision on the record evidence. The claim is made that the decision was based solely on the facts recited in the court's findings, and that the findings were incomplete. But the decision was not based solely on the recited findings. The court stated that it reached its conclusion only "After a careful study of the record made". (R. 79.)

The Tax Court stated the familiar rule that it was the taxpayer's burden to prove that the Commissioner's determination was erroneous. The court concluded "After a careful study of the record made * * * that petitioner has not successfully carried his burden of proof". (R. 79.) The taxpayer has attempted to equate this statement with its conclusion that the Tax Court's decision rested solely on the presumption of correctness of the Commissioner's determination. But the Tax Court's statement that the burden of proof was not carried is not the equivalent of saying that the presumption was not rebutted.

This case is manifestly unlike *Hemphill Schools* v. *Commissioner,* 137 F. 2d 961 (C.A. 9th), where the Board of Tax Appeals treated the presumption as if it were evidence, weighing it against taxpayer's evidence, and concluding that taxpayer's evidence did not overcome the presumption. There the Board held that "The evidence does not overcome the determination of respondent", thus making the error of elevating the presumption to the status of evidence. Here the court merely concluded that "the evidence does not establish that respondent erred". (R. 75.) The court did not base its decision, as in the *Hemphill Schools* case, on any failure to overcome a presumption. Rather, the court concluded that the taxpayer had not carried its "burden

of proof". (R. 79.) This burden was to overcome, not the presumption, but the volume of evidence which supported the Commissioner's position. See Rule 32, Rules of Practice before the Tax Court of the United States; cases cited in 9 Mertens, Law of Federal Income Taxation, Secs. 50.61, 50.62. In view of the fact that the record, which comprises 656 printed pages plus some 80 exhibits, contains so much evidence which indicates tax avoidance, the contention that the decision rests on a presumption is completely devoid of merit.

Nor is it of any moment that the Tax Court did not undertake in its written opinion to analyze the entire record. The court was not obliged to analyze the evidence in detail. It is sufficient that its decision is supported by substantial evidence, as here, in which case it should not be disturbed on appeal. *Meadow Lamp & Imp. Co.* v. *Commissioner,* 124 F. 2d 297, 300 (C.A. 3d). See also *Helvering* v. *Rankin,* 295 U.S. 123, 132-133; *Montrose Cemetery Co.* v. *Commissioner,* 105 F. 2d 238, 245 (C.A. 7th); *Hemphill Schools* v. *Commissioner,* 137 F. 2d 961 (C.A. 9th).

B. *Regardless of Section 129, American Pipe was not entitled to file consolidated tax returns*

Consider the case now without the application of Section 129. Here the taxpayer paid a premium for the stock of an unsuccessful, financially distressed corporation, known as a "loss corporation", in an attempt to offset the losses of the latter against its own profits and thereby avoid taxation. The danger to the Treasury of a scheme such as this is amply illustrated by the result which would occur if the position urged by the taxpayer in this case were adopted.

The predecessor of Palos Verdes was organized in 1921 to develop and promote real estate sales, but with little success. The original tracts of land, acquired at high prices, had lost much of their market value by 1935, when Palos Verdes was organized. Palos Verdes fared no better. The period from 1938 to 1943 was the worst in its financial history. (R. 53-54, 559-561, 586.) By 1942 its remaining lots were held by the State of California pursuant to tax sales, and subject to the liens of $97,406. (R. 53.) By December 2, 1943, American Pipe had acquired all of the stock of Palos Verdes for $11,248.96. (R. 60.) Before the end of December, 1943, some of the lots were purportedly sold to Dahlberg for $18,000. (R. 62-63, 289-291.) By applying the historical cost of Palos Verdes' predecessor, the tax basis to Palos Verdes was $250,781.80, and the resulting paper loss was $232,781.80. (R. 64.) American Pipe offset this paper loss against its profits on the consolidated tax return for 1943, and carried the excess forward to offset its profits in 1944 and 1945. (R. 52-53.) In January, 1944, most of the remaining lots were sold at auction for $16,185, the rest being lost for taxes to California within a few months thereafter. The historical basis to Palos Verdes was $183,797.91, and the resulting paper loss was $167,612.91. (R. 64-65.) This was reflected on the consolidated return for 1944, and carried forward as offsets against American Pipe's profits on the consolidated returns for 1945 and 1946. (R. 53.)

We refer to these losses as paper losses because neither American Pipe nor its stockholders actually incurred any loss at all. For that matter it is readily apparent that American Pipe actually realized an eco-

nomic gain, for Palos Verdes sold the lots for more than the stock cost American Pipe. In the strict legal sense losses did accrue to Palos Verdes. But in actuality they were suffered by the old stockholders of Palos Verdes who had sold their shares to American Pipe at a price which did not begin to approximate their capital contributions.

The question is whether under these circumstances American Pipe will be allowed to deduct the huge paper losses which neither it nor its stockholders incurred. An examination of the record will prove that the "principal purpose" which actuated the purchase of Palos Verdes stock was tax avoidance, and that, therefore, the losses must be disallowed to American Pipe because of Section 129. But even disregarding Section 129 for the moment, it is doubtful that the courts would allow Section 141 (the consolidated returns section) (Appendix, *infra*) to be so taken advantage of as to permit American Pipe, regardless of its reasons, to blatantly purchase $400,394.74 worth of someone else's losses for $11,248.96, and offset such fabricated losses against its own income. See *Woolford Realty Co.* v. *Rose*, 286 U. S. 319; *J. D. & A. B. Spreckels Co.* v. *Commissioner*, 41 B.T.A. 370.

In *Woolford Realty Co.* v. *Rose, supra*, the taxpayer was denied the right to file a consolidated tax return and offset against its income the losses of its subsidiary Piedmont corporation suffered by Piedmont in the two years preceding the acquisition of its stock by the taxpayer. The Supreme Court had this to say (pp. 329-330):

> Doubt, if there can be any, is not likely to survive a consideration of the mischiefs certain to be

> engendered by any other ruling. A different ruling would mean that a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious.

Allowing affiliated corporations to file consolidated returns has been recognized by Congress as sound in principle. It recognizes the business entity rather than the legal corporate separateness of the business operation. Inasmuch as it is ultimately the stockholders who suffer the gains or losses of the subsidiary, as well as those of the parent corporation, it would be unfair, where the affiliated group as a whole does not show a profit, to tax the profitable parent corporation separately without allowing the option to consolidate operations and thereby offset the losses of the unprofitable subsidiary. See congressional intent in permitting consolidated returns, set out in *J. D. & A. B. Spreckels Co.* v. *Commissioner, supra,* pp. 374-375. Basic to this reasoning is the thought that where the losses of the subsidiary actually cause an economic loss to the parent, offset against the parent's gains should be allowed.

However, where, as in the instant case, neither the parent corporation nor its stockholders have suffered any economic loss from the operations of the subsidiary, all reason for allowing consolidated returns vanishes. To rule otherwise would be to stretch the application of Section 141 to a situation far outside the scope of the congressional purpose. The Supreme Court, in the *Woolford Realty Co.* case, *supra,* would not countenance

such use of a consolidated return where it distorted the income picture of the parent.

True it is that in the *Woolford* case the loss had been incurred by the subsidiary Piedmont before its stock was acquired by the taxpayer. It was thus quite evident that the parent never really suffered the economic incidence of the loss. But it is no less evident that American Pipe did not incur the economic incidence of the loss in value of Palos Verdes' land. The real impact of the loss was felt by the old stockholders of Palos Verdes who held the stock as the land declined in value to almost worthlessness. Thus it may be said that the economic loss occurred before American Pipe acquired control, while the tax loss alone awaited the actual sale of the land for its realization. American Pipe purchased a corporation with a built-in loss feature awaiting only a taxable event, the sale, for its realization. After acquiring control, American Pipe wasted no time in causing Palos Verdes to realize the loss. Certainly the principle of the *Woolford* case is applicable here. American Pipe should not be entitled to file a consolidated return and thereby offset a loss, the economic incidence of which it never experienced.

J. D. & A. B. Spreckels Co. v. *Commissioner,* 41 B.T.A. 370, is a case in point. There the taxpayer for a nominal payment acquired all the stock of the Salvage Tire Company at a time when the latter had already contracted to sell its plant for a sizeable loss. The actual sale, and thus the realization of the loss, however, did not occur until after the taxpayer had gained control. The taxpayer then sought to offset the Tire Company's loss against its own profits on a consolidated tax return. The Board of Tax Appeals discussed the

Woolford case, recognizing that whether the affiliation there served a business purpose was not even considered, and concluded (p. 378) that—

> If Congress did not intend that the privilege of making a consolidated return should be enjoyed by a corporation which acquired ownership of another corporation in order to take advantage of a loss already sustained by that corporation, it seems to follow that Congress did not intend that the privilege should be enjoyed by a corporation which acquired the ownership of another corporation in order to take advantage of a loss certain to be sustained by that corporation in the immediate future, * * *

In a related situation the Tax Court again recognized that a deduction arising out of a transaction among affiliates will be scrutinized to see whether the taxpayer bore the economic cost of the sought-for deduction. In *Ericsson Screw Machine Products Co.* v. *Commissioner*, 14 T.C. 757, the Tax Court, in denying the taxpayer the use of its tranferor's basis for depreciating certain assets purportedly transferred pursuant to a plan of reorganization, pointed out (p. 764) the injustice of allowing the transferee to obtain the advantage of the transferor's basis—

> where those who indirectly owned the assets while they declined in value have terminated all chances of recoupment of their loss and the corporation claiming the high basis is one in which those persons have no stock interest. Congress has indicated no intention * * * to give strangers to the loss in value of the assets a basis which would enable them

to reap whatever benefits the future might reveal from the use or disposition of the assets.

See also *Kimbell-Diamond Milling Co.* v. *Commissioner,* 14 T.C. 74, affirmed, 187 F. 2d 718 (C.A. 5th).

It should be observed that the privilege of filing a consolidated return, with the accompanying advantage of inter-company offsets, is a departure from the underlying rule that the tax statutes have always "disclosed a general purpose to confine allowable losses to the taxpayer sustaining them, i.e., to treat them as personal to him and not transferable to or usable by another." *New Colonial Co.* v. *Helvering,* 292 U.S. 435, 440. The congressional purpose of limiting consolidated returns to that situation where the affiliated group as a whole has actually incurred an economic loss is given added meaning by Section 45 of the Code (Appendix, *infra*), where the Commissioner is authorized to distribute or allocate the gross income, deductions, or credits among the affiliated organizations in such a manner as to clearly reflect the income of the affiliates. See *Grenada Industries, Inc.* v. *Commissioner,* 17 T.C. 231, affirmed, 202 F. 2d 873 (C.A. 5th), certiorari denied, 346 U.S. 819.

Section 129 does not pre-empt the field. It was passed to foreclose a multitude of situations, where the acquisition of control of a corporation, or property of a corporation, results in making available to the acquiring person a deduction, credit, or allowance which would not otherwise have been enjoyed. The critical feature of Section 129 is that the acquisition must have been for the "principal purpose" of evading or avoiding tax. However, the reports of the congressional committees which handled the bill show that Section 129

was not intended to abrogate or supersede existing law, but rather to augment and bolster the decisions and sections already dealing with various problems of avoidance and distortion of income. The Senate Finance Committee Report stated that the principles established in *Higgins* v. *Smith,* 308 U.S. 473, and applied in *J. D. & A. B. Spreckels Co.* v. *Commissioner,* 41 B.T.A. 370, and other cases, are to be observed. S. Rep. No. 627, 78th Cong., 1st Sess., pp. 58-60 (1944 Cum. Bull. 973, 1016-1017). The Conference Committee Report makes clear that Section 129 was not meant to supersede the principles already established in the cases, nor the requirements of Sections 45 and 141. H. Conference Rep. No. 1079, 78th Cong., 2d Sess., pp. 55-56 (1944 Cum. Bull. 1059, 1070). It is stated in 7A Mertens, Law of Federal Income Taxation, 1954 Cum. Pocket Suppl., Sec. 42.145(a), p. 300, in reference to Section 129 that "It is clear that there was no intention to supersede or detract from the effectiveness, as an avoidance preventative, of I. R. C., Sec. 45, or Supreme Court decisions dealing with intercorporate transactions and the corporate entity."

We conclude that the law was, before Section 129 was adopted, and still is, that since the scheme adopted by American Pipe grossly distorted the income of the affiliated corporations, it was not entitled to file consolidated tax returns regardless of its motives for acquiring the stock of Palos Verdes. *Woolford Realty Co.* v. *Rose,* 286 U.S. 319.

CONCLUSION

For the reasons advanced above, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

SEC. 45 [As amended by Sec. 128(b) of the Revenue Act of 1942, c. 63, 58 Stat. 21]. ALLOCATION OF INCOME AND DEDUCTIONS.

In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

(26 U.S.C. 1952 ed., Sec. 45.)

SEC. 129 [As added by Sec. 128(a) of the Revenue Act of 1943, *supra*]. ACQUISITIONS MADE TO EVADE OR AVOID INCOME OR EXCESS PROFITS TAX.

(a) *Disallowance of Deduction, Credit, or Allowance.*—If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose

for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clause (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

(b) *Power of Commissioner to Allow Deduction, Etc., in Part.*—In any case to which subsection (a) is applicable the Commissioner is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

(26 U.S.C. 1952 ed., Sec. 129.)

SEC. 141 [As amended by Sec. 159(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. CONSOLIDATED RETURNS.

(a) *Privilege to File Consolidated Income and Excess-Profits-Tax Returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making consolidated income and excess-profits-tax returns for the taxable year in lieu of separate returns. The making of consolidated returns shall be upon the condition that the affiliated group shall make both a consolidated income-tax return and a consolidated excess-profits-tax return for the taxable year, and that all corporations which at any time during the taxable year have been members of the affiliated group making a consolidated income-tax return consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated income-tax return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated returns shall include the income of such corporation for such part of the year as it is a member of the affiliated group. * * *

* * * * *

(d) *Definition of "Affiliated Group".*—As used in this section, an "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 94 per centum of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

* * * * *

(26 U.S.C. 1952 ed., Sec. 141.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 20.129-1 [As added by T. D. 5426, 1945 Cum. Bull. 196.] *Meaning and Use of Terms.*—As used in section 129 and in sections 29.129-2 to 29.129-5, inclusive—

(a) The term "allowance" refers to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among other things, a deduction, a credit, an adjustment, an exemption, or an exclusion.

(e) The term "person" includes an individual, a trust, an estate, a partnership, a company, or a corporation.

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